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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

Nos. 127, 128

FEDERAL POWER COMMISSION, MEMPHIS LIGHT, GAS AND WATER DIVISION, *Petitioners,*

v.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPE LINE COMPANY OF AMERICA, AND TEXAS EASTERN TRANSMISSION CORPORATION, *Respondents.*

On Writs of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF OF INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA, AMICUS CURIAE, IN SUPPORT OF RESPONDENTS

This brief, *amicus curiae,* is filed with the consent of the parties.

INTEREST OF AMICUS CURIAE

Independent Natural Gas Association of America (INGAA) is a non-profit trade association whose membership includes most of the interstate natural gas pipeline companies subject to the jurisdiction of the

Federal Power Commission (Commission).[1] For many years INGAA has appeared in rule-making, rate and certificate proceedings before the Commission involving issues affecting the natural gas industry generally. It has participated in proceedings before this Court and the various Federal appellate courts in cases arising out of Commission action.

Since many natural gas pipeline companies are engaged in non-jurisdictional operations directly or through affiliates, it is manifest that INGAA's member companies have an important interest which may be affected by this Court's action in the instant proceeding.

OPINIONS BELOW

The opinion of the court of appeals (II R. 70-72)[2] is reported at 357 F. 2d 230. The opinion and order of the Commission (II R. 32) are reported at 31 F.P.C. 1180. The Commission's decisions on the applications for rehearing are reported at 32 F.P.C. 687, 879, and 1163.

JURISDICTION

The judgment of the court of appeals setting aside the Commission's order was entered on February 10, 1966 (II R. 73-74). The petitions for certiorari were filed on May 11, 1966, and granted on June 13, 1966

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[1] For convenience United Gas Pipe Line Company is referred to as United; Union Producing Company as Union; United Gas Corporation as Gas Corporation; and United Overseas Production Corporation as Overseas.

[2] The record in this Court consists of Joint Appendix, Volume I below, referred to herein as "I.R.," and Joint Appendix, Volume II below (as supplemented by the opinion of the court of appeals and other pleadings and documents in the court of appeals and in this Court), referred to as "II R."—the two volumes being bound together but paginated separately.

(II R. 75-76, 384 U.S. 984). The jurisdiction of this Court rests on 28 U.S.C. 1254 (1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTION PRESENTED

When a company making sales of natural gas subject to rate regulation by the Commission under the Natural Gas Act joins in a consolidated Federal income tax return with affiliates which have net tax losses in connection with unrelated and non-jurisdictional (non-utility) activities, may the Commission reduce the income tax allowance used in computing the rates for sales subject to its jurisdiction by utilizing all or part of such unrelated and non-jurisdictional tax losses?

STATUTES INVOLVED

The pertinent provision of the Natural Gas Act, 52 Stat. 821-833, as amended, 15 U.S.C. 717-717w, and of the Internal Revenue Code of 1954, 68A Stat. 3 *et seq.*, as amended, 26 U.S.C. 1, *et seq.*, are set out in Appendix A to the Brief in No. 127.

STATEMENT

In order to avoid repetition, we adopt the statements of facts set out in the briefs of respondents.

SUMMARY OF ARGUMENT

Although Petitioners' *briefs*[3] would leave the impression that the tax losses here involved pertained to Union's jurisdictional, *i.e.* gas production business, the Commission's *opinion* under review makes it clear that these tax losses stemmed from non-jurisdictional, *i.e.* oil, operations unrelated to United's jurisdictional gas

[3] Emphasis supplied throughout unless otherwise noted.

sales. Thus, the question presented concerns the propriety of appropriating the benefits of such *non-jurisdictional* losses to reduce United's jurisdictional rates.

Since the Commission now acknowledges that in its opinion under review it appropriated *all* the benefits of these non-jurisdictional (oil) tax losses for United's so-called jurisdictional activities and that such appropriation goes too far, the Commission's request for reversal of the judgment below improperly seeks reinstatement of an admittedly erroneous Commission order. Moreover, the sharing theory underlying this request played no part in that Commission opinion and so, under established principles, is not now available to support the Commission's action. *E.g. S.E.C.* v. *Chenery Corp.*, 318 U.S. 80, 87-88 (1943). In any case, since the new theory, even if accepted, would not result in any modification of the judgment below, a ruling thereon would be purely advisory and beyond this Court's power to issue.

I

The court below properly held to be applicable here the Tenth Circuit's holding in *Cities Service*, 337 F. 2d 97, that the comparable Commission order there involved violated the "rate-principle of separating regulated and unregulated profits and losses." In light of the Commission's limited statutory jurisdiction, the Commission and the courts have repeatedly affirmed that the costs and expenses associated with activities not subject to Commission regulation must be excluded from any determination of rates for sales subject to the Commission's jurisdiction; "otherwise the profits or losses * * * of the unregulated company would be assigned to the regulated business and the Commission

would transgress the jurisdictional lines which Congress wrote into the act." *Panhandle Eastern Pipe Line Co.* v. *F.P.C.*, 324 U.S. 635, 641-642 (1945).

United's jurisdictional customers have not supplied any of the capital for the non-jurisdictional oil operations of Union and Overseas. Nor could they be—nor have they been—called upon to bear any of the expenses, risks, or losses of these non-jurisdictional activities. Indeed, the rates charged to United's jurisdictional customers are no higher by virtue of United's joining in a consolidated return with Union than they would have been if United were an independent company and filed a separate return. Accordingly, the Act's prohibition against allocating non-jurisdictional profits or losses to jurisdictional operations also bars appropriation of any part of the tax benefits of these non-jurisdictional losses for the jurisdictional customers. Under the Commission's contrary argument, the jurisdictional rates would fluctuate with the success or degree of failure of non-jurisdictional activities; the greater the losses from non-jurisdictional operations, the lower the jurisdictional rates—and vice versa—even though every element of the jurisdictional cost of service remained unchanged.

II

A. Petitioners' claim, that a sharing of the benefits of the non-jurisdictional tax losses is proper because United's taxable income was necessary to the realization of these benefits, has no foundation in fact even assuming, *arguendo*, that such arguments may be considered at this time. First, contrary to Petitioners' arguments, the unchallenged evidence in the record shows that Union could itself have generated enough

taxable income to realize the full benefits of its tax losses under the carry-back and carry-forward provisions of Section 172 of the Internal Revenue Code.

Second, while Petitioners' arguments would treat United as entirely regulated, the Commission admits that only 44% of United's sales are subject to its jurisdiction. If United's taxable income were divided into its jurisdictional and non-jurisdictional segments, United's non-jurisdictional taxable income alone would be more than adequate to realize the full benefits of Union's non-jurisdictional tax losses. In addition, the Commission improperly treated the Gas Corporation as regulated; in fact, it is not regulated at all by the Commission and its taxable income over the critical period was nearly 3 times Union's tax losses. Thus, United's jurisdictional taxable income plainly is not needed to realize the full benefits of Union's tax losses, particularly since the Commission itself recognized (Br., p. 7) that "* * * any losses sustained by an unregulated company or activity must first be set off against the total income of *all unregulated operations.*"

Third, United's rate payers are not underwriters or guarantors of, and/or partners in, Union's non-jurisdictional oil business. Not only are United's jurisdictional rates fixed at a level no higher than necessary to recoup the jurisdictional cost of service (including a non-confiscatory return), but the jurisdictional customers have no liability to creditors of United or Union should either of them become delinquent and fail to pay expenses or costs incurred by them. Rather, the only obligation of jurisdictional customers is to pay for the gas delivered to them as in any other conventional sale of a service or a commodity. And, as in a conventional

sale, once United's jurisdictional customers pay for their gas, they have no interest either in the monies thus paid over or in what United's stockholders decide further to do with these monies.

Fourth, United's ratepayers do not bear any higher costs of capital attributable to Union's allegedly riskier exploration and development operations. The Gas Corporation's cost of capital—which the Commission used in determining United's rate of return—is *lower* than United's separate cost of capital, rather than higher as implied by Memphis. Moreover, the alleged high profitability of Union's production activities may very well have been an important factor in keeping down the Gas Corporation's cost of capital. Indeed, it appears that Union has contributed more than it has received as far as United's jurisdictional customers are concerned.

B. Aside from the factual infirmities in Petitioners' arguments, there are several legal obstacles to their proposed appropriation of a part of Union's non-jurisdictional tax losses for United's jurisdictional rates: First, by depriving the United group of all or part of the benefits of these tax losses, such appropriation would frustrate the purposes of the offset provisions of the tax laws to stimulate investments by mitigating the impact of loss operations. That purpose is apparent not only from the legislative history of these provisions, but also from the fact that under these provisions the *government* shares a company's losses with its stockholders and hence they operate to reduce a minus (loss), not to add a plus (profit).

Second, such appropriation would improperly impair the ability of regulated companies effectively to compete in non-jurisdictional activities. The effect

of depriving a regulated company of the benefits of non-jurisdictional tax losses would place them at a disadvantage vis-a-vis their unregulated competitors who would be able to retain the full benefits of their tax losses. As a result, regulated companies would be deterred from undertaking non-jurisdictional ventures and unregulated companies would be discouraged from undertaking or acquiring regulated businesses.

Third, such appropriation would adversely affect the Gas Corporation's stockholders. The tax regulations (Sections 1.1502-34 and 1.1502-35) provide for a reduction in a parent company's tax basis on its investment in a subsidiary by the amount of the loss utilized through a consolidated return. Hence, should the Gas Corporation sell or abandon the non-jurisdictional operations of Union, it would be deprived of the benefits of the tax losses previously offset through the use of consolidated returns even though the actual benefits thereof had been passed on to United's jurisdictional customers.

Finally, such appropriation would conflict with the oil exploration and development incentives provided by Congress. The effect of passing on to United's jurisdictional customers all or even part of the benefits of the tax losses resulting from the use of these incentives, is to put to naught the Congressional purposes underlying the tax provisions which make possible these tax losses.

III

Contrary to the arguments of the Commission and Memphis, the applicable precedents support the result below, rather than that urged by them. None of the several Commission cases upon which they rely in-

volved the question here presented; rather, they related to the determination of an equitable allocation of tax deductions, particularly interest expenses, incurred by a parent on behalf of its subsidiaries. Hence, the real problem in those cases was that of allocating to jurisdictional operations the full costs associated therewith.

On the other hand, the case which the Commission would now classify as an exception, *Olin Gas Transmission Corp.*, 17 F.P.C. 685 (1956), is the only prior Commission decision specifically dealing with the present issue. There the Commission specifically recognized the impropriety of appropriating tax losses of non-jurisdictional activities to reduce jurisdictional rates. This result is supported by the decision of various State courts and regulatory commissions which have had occasion to consider the problem.

ARGUMENT

INTRODUCTION

One might get the impression from reading the briefs of the Commission and Memphis that the tax losses of Union and Overseas which the Commission utilized to reduce United's income tax allowances were in effect incurred by United and pertained to related jurisdictional, *i.e.* gas, production activities, and hence that the issue here concerned the propriety of the Commission utilizing such related jurisdictional tax losses to reduce the income tax allowed in United's jurisdictional cost of service. For example, the Commission's Summary of Argument (Br., p. 9) describes the holding below without even a reference to separate unrelated and non-jurisdictional oil operations of Union and Overseas, *i.e.*, as involving a situation

"where an *integrated gas* utility system files consolidated Federal income tax returns, in which the tax losses of the *producing* affiliates are offset against the taxable income of the transmission and distributing members * * *." See, also, the Commission's Brief at pp. 10, 21, 22, 23; Memphis Brief at pp. 11, 12, 17-20, 28.

The fact is, however, that tax losses arising from related jurisdictional gas operations are not involved in, nor are a part of, the question which the Commission and the court below undertook to decide in the opinions here under review. In short, there is no issue here presented with regard to related jurisdictional tax losses of Union. To the contrary, the issue presented relates to the propriety of using the tax losses resulting from *unrelated* and *non-jurisdictional* oil operations of Union and Overseas,[4] corporate entities separate and distinct from United, to reduce the income taxes allowed in United's cost of service for the benefit of its jurisdictional gas customers.[5]

In this regard, it is noteworthy that contrary to the Commission's assertion (Br., p. 21) that the record does not disclose the extent of the tax losses attributable to Union's oil operations, the Commission in

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[4] Although Overseas' non-jurisdictional losses were comparatively small, they illustrate graphically the problem and principle here involved.

[5] See, *e.g.*, the Stipulation of Commission Staff counsel at the hearings (I.R. 120):

> "The consolidated tax technique will give to the benefit of United Gas Pipe Line customers * * * an effective tax rate lower than 52 per cent, and * * * this results from the taking into account Union's losses on oil as well as Union's losses on gas."

its opinion expressly recognized that "* * * the record would permit an allocation of Union's taxable income between its regulated and non-regulated business" (II R. 42). Such an allocation is set out in Appendix D to United's brief which shows that the net *tax losses,* incurred by Union over the five-year period (1957-1961) utilized by the Commission, are in fact wholly attributable to Union's *oil* operations, *with its gas operations having a net taxable income over that period.*

It also is important to emphasize at the outset that the Commission is not here quarreling with the *judgment* of the court below setting aside the Commission's order herein. The Commission itself recognizes that it went too far in utilizing *all* the benefits of Union's and Overseas' non-jurisdictional tax losses to reduce the taxable income of the so-called regulated companies in the United Group. Not only does the Commission state in its Petition for Certiorari (at p. 10, fn. 8):

> "There may indeed be problems in the application of the particular formula used by the Commission in this case, a formula which may result in allocating the entire tax saving resulting from losses on unregulated activities to the regulated members of the consolidated group,"[6]

but it explicitly recognizes in its brief on the merits that such, indeed, is the result reached in the Commission's opinion here under review. Thus, it expressly notes

[6] It bears noting that the use of the formula would result in appropriating *all* of "tax saving" not used up against non-jurisdictional taxable income, for "regulated members of the consolidated group" *in all cases,* not just "in this case." Thus, contrary to the Commission's argument (Br., p. 15), the Commission's approach in its opinion here under review in fact no more involves allocation than does the ruling below.

(at p. 15) that "the particular formula utilized by the Commission * * * as applied to the facts of this case, results in allocating the whole of the savings to the companies that had taxable income" *i.e.* to the "regulated members of the consolidated group."

Despite this recognition of basic error in the Commission's order here under review, the Commission now asks (at p. 28) for reversal of the judgment below (see, also, Memphis Br., p. 29) and attempts to support such relief by urging error on the part of the court below because it failed to recognize an alleged propriety of a *sharing* of the benefits of the non-jurisdictional tax losses.[7]

But the effect of granting the reversal urged by the Commission would be to reinstate the Commission's order which the Commission now admits is erroneous. Moreover, this sharing theory played no part in the Commission decision herein. Nor was it urged upon the court below. Instead, the Commission and Memphis there sought affirmance of the Commission's appropriation of *all* the benefits of the non-jurisdictional tax losses for the so-called regulated companies in the United Group.

It is well established that judicial review of administrative action is far narrower than review of trial court decisions in that the courts may judge an administrative order only upon the grounds on which the agency based its action "for purposes of affirming no

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[7] It is interesting to observe, however, that while the Commission and Memphis now press a "sharing" concept, neither suggest what would be a "fair" sharing of the benefits of the non-jurisdictional tax losses.

less than reversing its orders," *S.E.C.* v. *Chenery Corp.*, 318 U.S. 80, 87, 88 (1943); see, also, *e.g.*, *Texas Gas Transmission Co.* v. *Shell Oil Co.*, 363 U.S. 263, 270 (1960); *American Trucking Ass'ns, Inc.* v. *United States*, 364 U.S. 1, 14 (1960). In these circumstances, we submit, the court below did not commit error in not dealing with the new approach now being advanced by the Commission and Memphis—particularly since the use of such approach would, in any event, be improper, and, even if adopted, would not alter the judgment of the court below.

Indeed, since the new approach now being urged by the Commission and Memphis would not affect the judgment entered by the court below, it would appear that what they seek from this Court is "a useless and profitless reversal" in the form of an advisory opinion, which this Court has traditionally held that it has no jurisdiction to issue. *Flournoy* v. *Wiener*, 321 U.S. 253, 262 (1944) and cases there cited; *Lederer* v. *McGarvey*, 271 U.S. 342, 344 (1926); *Aetna Life Insurance Co.* v. *Haworth*, 300 U.S. 227, 240-241 (1937) and cases there cited. In any case, as we will now show, not only is the substantive ground on which the court below based its decision eminently sound, but the new rationale of the Commission and Memphis has no foundation either in fact or in law.

I

The Commission's Utilization of Union's and Overseas's Non-Jurisdictional and Unrelated Tax Losses To Determine United's Tax Allowance Transgresses the Limitation Upon the Commission's Jurisdiction

In setting aside the Commission's order here under review, the court below ruled that the Commission acted "contrary to the requirements which Congress has imposed" (II R. 72) by reducing United's income tax allowance because another of the "affiliated companies which is not subject to Federal Power Commission jurisdiction, sustained losses" (II R. 21). As already noted earlier, the court below thereby agreed with the decision of the Court of Appeals for the Tenth Circuit in *Cities Service Gas Co.* v. *F.P.C.*, 337 F. 2d 97 (1963), and expressly noted "that the principles which are announced in [the *Cities Service*] opinion are here applicable and controlling" (II R. 72).

In the *Cities Service* decision, thus approved and followed by the court below, the relevant facts closely paralleled those which the Commission understood were presented in this case. Indeed, the Commission's opinion here undertakes to apply the formula used in *Cities Service* in determining the so-called "effective consolidated tax rate" for United. In the *Cities Service* case, the Commission had similarly undertaken to appropriate the net tax losses of domestic and foreign non-jurisdictional and unrelated affiliates to reduce the income tax allowance included in the cost of service for jurisdictional operations. 30 F.P.C. 158. The Tenth Circuit reversed, holding that the Commission's action violated the well-established "rate-principle of separating regulated and nonregulated profits and losses" (337 F. 2d at 99). Further noting that the

Commission had been careful to comply with this principle in other respects (*Id.* at 98-99),[8] the Tenth Circuit ruled (*Id.* at 100-101):

> "We know, of course, that the Commission is free to choose most any method which it deems appropriate in the determination of just and reasonable rates for jurisdictional gas sales—usually a legitimate end justifies the means. [citations omitted] But, we know equally well that the method utilized must surely be within acknowledged jurisdictional limits which require an effective separation of regulated and nonregulated activities for the determination of the ingredients of the rate base. As applied to our case, it means a separation of profits and losses between regulated and nonregulated businesses in determining the tax allowance includible in the cost of service of the regulated company. * * *"

Basic to the disposition of this proceeding, as well as to *Cities Service,* is the fundamental rate-making principle, which, as the Commission recognized in *Cities Service* (30 F.P.C. at 162), requires "a separation between regulated and unregulated costs and revenues." For when the true thrust and scope of this principle is fully brought to bear, it becomes clear not only that this principle has been violated by the Commission in this proceeding, as in *Cities Service,* but

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[8] The Commission's *Cities Service* opinion expressly recognizes that "the fundamental ratemaking principle governing our disposition of this issue requires a separation between regulated and unregulated costs and revenues" (30 F.P.C. at 162), and acknowledges that "This principle controls our allocation of other costs which are jointly incurred by regulated and unregulated companies or departments within the same company, and is controlling here" (*Ibid.*).

that as a result of that violation, the Commission has exceeded its jurisdiction under the Natural Gas Act.

It is, of course, a truism that the Federal Power Commission, as an agency created by Congress, has only such jurisdiction as is bestowed upon it by Congress. For the present purposes, the only statute pertinent, so far as the Commission's jurisdiction is concerned, is the Natural Gas Act. Examination of that Act leaves no doubt that the Commission's authority thereunder extends only to regulation of the natural gas business. Section 1(b) of the Act expressly states:

> "The provisions of this act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, * * *."

Even this authority does not extend to all facets or segments of that business. Thus, Section 1(b) goes on to provide that the Act's provisions:

> "* * * shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas" (see, also, Section 1(c)).

Manifestly the Commission's limited jurisdiction over natural gas does not extend to domestic and overseas oil operations, which generated the tax losses involved in this case.

In view of the above express statutory limitations, pipeline rate proceedings before the Commission—which are based on the cost of service concept—have

long proceeded on the premises (1) that the rates fixed for sales subject to the Commission's jurisdiction should be based solely upon income and expenses incurred in connection with such sales; and (2) that where the pipeline company involved also is engaged in non-jurisdictional sales or activities, the income and expenses associated therewith must be separated out in order to assure that the Commission keeps within its jurisdictional bounds. See, *e.g.*, *Mississippi River Fuel Corp.*, 4 F.P.C. 340, 351, 355-6, *aff'd in part, Mississippi River Fuel Corp.* v. *F.P.C.*, 163 F. 2d 433 (D.C. Cir., 1947); *Interstate Natural Gas Co.*, 3 F.P.C. 416, 428 (1943), *aff'd, Interstate Natural Gas Co.* v. *F.P.C.*, 156 F. 2d 949 (5th Cir., 1946), *aff'd*, 331 U.S. 682 (1947), *Cities Service Gas Co.*, 3 F.P.C. 459, 485 (1943). For example, in the *Mississippi River Fuel* case, the Commission stated (4 F.P.C. at 351):

> "* * * Mississippi has then two classes of customers—utility and industrial. The rates for gas sold directly to industrial customers are not subject to our jurisdiction, so it is necessary to make an allocation of costs of service to segregate the regulated and unregulated business."

Since the Commission has in the past consistently abided by these jurisdictional limitations, there has been a paucity of cases in which the courts have had to deal with claims that the Commission exceeded its jurisdiction by taking into account non-jurisdictional income and expenses in determining jurisdictional rates. However, in the few cases in which such an issue has been raised, the courts have affirmed the principle that the rates fixed by the Commission for sales subject to its jurisdiction must be based solely upon the costs and expenses associated with these sales.

Colorado Interstate Gas Co. v. *F.P.C.*, 324 U.S. 581 (1945); *Panhandle Eastern Pipe Line* v. *F.P.C.*, 324 U.S. 635 (1945); *Mississippi River Fuel Corp.* v. *F.P.C.*, 163 F. 2d 433, 437 (D.C. Cir., 1947); cf. *Smith* v. *Illinois Bell Telephone Co.*, 282 U.S. 133 (1930). In the *Colorado Interstate* case, where the company claimed, *inter alia*, that the Commission had improperly taken non-jurisdictional operations into consideration in fixing jurisdictional rates, this Court stated (324 U.S. at 593-4):

> "* * * The Commission included in the total cost of service for these companies a 6½ percent return on the rate base (Fn. omitted). In other words, the 6½ percent return was computed on the basis of all the property used by petitioners in their various classes of business—intrastate sales, direct industrial sales, and interstate wholesale sales. (Fn. omitted). Now it is apparent *that if the reduction ordered was based on the excess of revenues from all classes of business over the aggregate costs, the result would be to reduce to a common level the profits from each class. In that case, whenever a company was making a higher return on its unregulated business than the rate of return allowed for the regulated business, the excess earnings from the unregulated part would be appropriated to the entire business.* When the unregulated business was being operated at a loss or at less than the return which was allowed, excess earnings from the regulated business would be appropriated to the unregulated business * * *.
>
> "* * * It is said that that is what happened here. But that is not true. *As we have seen, the Commission ordered a rate reduction based solely on the excess of revenues over costs (including return) derived from the regulated business. None of the excess revenues over costs (including return) from the unregulated business was included in that reduction.*"

And in the *Panhandle Eastern* case, where the question again was raised in the context of the Commission's alleged failure to allocate the Company's properties and costs between jurisdictional and non-jurisdictional business, this Court similarly commented (324 U.S. at 641-2):

> "We agree that the Commission must make a separation of the regulated and unregulated business when it fixes the interstate wholesale rates of a company whose activities embrace both. *Otherwise, the profits or losses, as the case may be, of the unregulated company would be assigned to the regulated business and the Commission would transgress the jurisdictional lines* which Congress wrote into the Act."[9]

The same reasoning, we submit, requires that the limitations on the Commission's jurisdiction be respected so as not to transfer to United's jurisdictional customers the tax benefits flowing from the unrelated and non-jurisdictional (oil) tax losses of Union and Overseas. As shown below, the jurisdictional customers of United did not supply any of the capital used for investment in those operations of Union and Overseas in connection with which these tax losses were incurred. Nor could United's jurisdictional customers be—nor have they been—called upon to bear any part of the expenses, risks or losses which might be incurred in connection with those operations. To the contrary, the Commission has gone to great pains to

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[9] Although the *Colorado Interstate* and *Panhandle Eastern* cases involved jurisdictional and non-jurisdictional activities of a single corporate entity, the principle is, as the Commission recognized in *Cities Service* (30 F.P.C. at 162), fully applicable to jurisdictional and non-jurisdictional activities of corporate affiliates.

assure that its determination of the cost of service for United's business subject to Commission jurisdiction include only those costs incurred in connection therewith.

In other words, the revenues and expenses of United's jurisdictional business have scrupulously been kept separate and distinct from all non-jurisdictional business of the United group, including the unrelated and non-jurisdictional business of Union and Overseas, and hence do not have any tie with, or relationship to, the tax losses attributable to the non-jurisdictional oil business of Union and Overseas. See II R. 54. Thus, United's joining in a consolidated return with Union and Overseas did not operate to increase the rates charged to United's jurisdictional customers over what they would have been if United were not affiliated with Union and Overseas and had filed its own separate return.

In these circumstances, since the Natural Gas Act precludes the Commission from allocating any part of the profits or losses of non-jurisdictional activities to jurisdictional operations, the Act *a fortiori* bars the Commission from transferring the tax benefits of such non-jurisdictional losses to the jurisdictional customers. Significant in this regard is the Commission's express acknowledgment in *Cities Service,* 30 F.P.C. at 162 that:

> "* * * If we were to allocate the consolidated system tax return among all profit companies including those in whole or part engaged in unregulated activities, there would be no sound reason for refusing to fix jurisdictional rates at a level sufficient to make up any real losses these companies might suffer."

By the same token, the converse is equally true. Since the statute precludes the fixing of the jurisdictional rates at a level sufficient to make up the losses, tax or otherwise, of the non-jurisdictional activities, there is no basis in the statute—or in logic or equity—to allocate to the jurisdictional activities the benefits of non-jurisdictional tax losses.

The impropriety of the Commission's approach is emphasized by the fact that it leads to highly incongruous results. Every time the amount of non-jurisdictional tax losses changes, the consolidated effective tax rate would similarly change. This would be accentuated where, as here, a major non-jurisdictional activity is oil exploration and development, since that business is typified by wide swings in earnings and tax losses. Moreover, under the Commission's approach, the tax allowable to United *bears no relationship whatsoever to the taxable income generated by United's jurisdictional business,* and the level of United's rates would depend upon the success or degree of failure of the non-jurisdictional activities of Union and Overseas —the greater the losses from non-jurisdictional operations, the lower would be United's jurisdictional rates. Similarly, the less the losses from non-jurisdictional operations, the higher would be United's jurisdictional rates. *And this would be so even though every element of United's jurisdictional cost of service remains unchanged.* The very fact that natural gas rates subject to the Commission's jurisdiction would go up or down, depending on the profitability or degree of non-profitability of non-jurisdictional operations of affiliates, is proof-positive of the illegality and impropriety of the Commission's action here involved.

II.

The Inclusion of United in Consolidated Returns Does Not Justify Allocating to It Any Part of the Benefits of the Unrelated and Non-Jurisdictional Tax Losses of Union and Overseas

Ignoring the jurisdictional ground on which the court below set aside the Commission's order herein and, indeed, as already noted, conceding that the Commission had in fact erred in utilizing the full amount of Union's and Overseas' tax losses as an offset against the taxable income of the so-called "regulated" companies, the Commission now argues that the court below erred in failing to recognize that a *sharing* of the benefits of the tax losses could properly have been required.[10] Thus, claiming (Br., p. 16) that the taxable income of the "regulated companies" was "indispensable to the realization of tax savings from the tax losses of the producing companies," the Commission now asserts (Br., pp. 16-17):

> "Without tax losses to set off against taxable income, there would, of course, have been no tax benefit to be obtained by filing consolidated returns. Equally, however, without taxable income the tax losses could not have been translated into tax savings. If United and Gas Corporation had not had any taxable income, the group would not

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[10] As pointed out earlier herein, the Commission neither based its decision herein on the theory of sharing the benefits of the net tax losses, nor did it urge any such result upon the court below. Rather, the entire thrust of its argument to the court below was in support of the result which the Commission now admits to be erroneous. Consequently, the several arguments advanced by the Commission and Memphis in support of such sharing suffer from the basic infirmity that well settled principles preclude their consideration in support of the Commission's action here. *E.g. S.E.C.* v. *Chenery Corp.*, 318 U.S. 80, 88 (1943).

> have received, as it did, the equivalent of a $2 million rebate as a result of the producing member's losses. And since the income was very largely contributed by United ratepayers [fn. omitted] we submit that they are entitled to share in the resulting tax benefit."

These arguments have no foundation either in fact or law.

A. The Taxable Income of United's Jurisdictional Business Was Not Needed to Realize the Benefits of the Non-Jurisdictional Tax Losses

The assumption, underlying the Commission's present argument for a sharing of the benefits of the non-jurisdictional tax losses, namely, that the taxable income of United's jurisdictional business was necessary to realize the benefits of these non-jurisdictional tax losses, is, as shown below, without support or justification in the record and, indeed, is contrary to the evidence therein. In addition, as also shown below, the non-jurisdictional operations of the consolidated group are "in nowise supported by the pipeline operations" (*Cf.* Comm. Br., p. 15). Consequently, the two conditions which the Commission claims is necessary to give "cogency" to the holding below (Br., p. 15),[11] are, in fact, present in this case.

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[11] As stated by the Commission (Br., p. 15), the holding below "might have considerable cogency if the tax savings were indeed wholly attributable to the non-pipeline operations of the consolidated group, and if, in addition, those operations were in nowise supported by the pipeline operations. * * *"

1. Union Would Have Realized the Full Benefits of Its Tax Losses Without the Taxable Income of United's Jurisdictional Business

While it is true, of course, that tax losses may go to waste in the absence of offsetting taxable income, the record here is clear that Union could itself have generated enough taxable income to realize the full benefits of its tax losses under carry-back and carry-forward provisions of Section 172 of the Internal Revenue Code,[12] and hence that none of United's jurisdictional taxable income was in fact needed to realize the benefits of Union's tax losses.[13] Thus, United's witness Dunn expressly testified that a study made by him " * * * proves conclusively that whether a consolidated return basis is used or a separate return basis is used, Union, itself, can use all of its tax reductions. Therefore, there is no tax loss that is ever of any use to the other two companies" (I.R. 71-72). Significantly, no one challenged this testimony.

In contrast to the complete absence of controversy on this matter *at the hearing*, the Commission would now argue to this Court that the provisions of Section 172 are irrelevant because (Comm. Br., p. 18; see also Memphis Br., pp. 13-14, 22-23):

> "These provisions depend upon the loss corporation's having taxable income within prescribed time periods sufficient to absorb the losses and there is no indication that these are likely contingencies for the producing members of the United system [fn. omitted]."

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[12] Section 172 provides that tax losses may be carried back three years and carried forward for five years. This makes a total of nine years, including the year in which the tax return is filed, in which losses can be offset against income.

[13] The argument in the text is made in terms of Union's non-jurisdictional tax losses for simplicity.

However, as testified to by Mr. Dunn (I.R. 100):

> "* * * Union being a producing company, its tax deductions are controllable. Union can control how many wells it drills in any year, and one of the main items of tax deduction is well drilling expense, both producing wells and non-producing wells, and in any given period of time Union can control to a very large extent how many wells it drills, so that there is no reason whatever to assume that Union Producing Company, being a highly successful production company and with large gas and oil reserves, proven oil reserves, would ever be in a position of not being able to utilize its tax deductions."

2. The Non-Jurisdictional Taxable Income of the United Group Is Ample To Realize the Full Benefits of Union's Non-Jurisdictional Tax Losses

Quite apart from the carry-back and carry-forward provisions of Section 172, it is clear that the taxable income attributable to United's *jurisdictional* business is not needed to obtain the benefits of Union's and Overseas' non-jurisdictional tax losses. Significantly, no finding or argument to the contrary has even been made either in the Commission's opinion or in the briefs filed herein by the Commission and Memphis. Instead, the Commission reached the result it did by treating United as if it were regulated by the Commission *in its entirety* although the record shows (II R. 54), and the Commission now recognizes (Br., p. 3), that *only 44 percent* of United's sales of natural gas are subject to Commission regulation.[14]

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[14] The same group of exhibits on which this Commission statement is based shows that of the 56% of United's sales not subject to Commission regulation, about 9% is subject to state regulation as so-called town border sales and the remaining 47% are direct sales not subject to any regulation.

The Commission obviously has no more authority or power with regard to 56 percent of United's sales—which, the Commission implicitly admits, is not subject to its jurisdiction—than it has with regard, for example, to the oil production activities of Union and Overseas. Indeed, as mentioned earlier, the Commission has gone out of its way to adhere in all other respects to a strict segregation of revenues and costs between United's jurisdictional business, on the one hand, and its non-jurisdictional business, on the other. Consequently, there is no reason or justification for the Commission to treat as regulated the non-jurisdictional portion of United's business in determining the income tax allowance to be included in United's jurisdictional cost of service.

Had the Commission allocated United's total taxable income as shown for each year in Exhibit 36 (Revised) (II R. 24) between United's jurisdictional (44%) and non-jurisdictional sales (56%), it would have found that United *alone* had more than enough *non-jurisdictional taxable income* in each year of the period 1957-61 (here used) to offset all of Union's non-jurisdictional tax losses and thereby realize the full benefits of these tax losses. Hence, when United's operations are properly classified in accordance with the limitations upon the Commission's jurisdiction, it is plain that in not one of the five years used by the Commission was United's jurisdictional taxable income in fact needed to realize any part of the benefits of the non-jurisdictional oil tax losses.

That there is no need for United's jurisdictional taxable income to realize the benefits of the non-jurisdictional tax losses can be further seen from the fact that the same Exhibit 36 (Revised) also shows that the

Gas Corporation's taxable income—all of which is non-jurisdictional as far as the Commission is concerned—is nearly three times as great as Union's net taxable losses over the 1957-61 period.

The foregoing also answers the Commission's further claim (Br., pp. 17-18; see also Memphis Br., pp. 23-27) that it is improper:

> "to say that United did not contribute to the tax savings because Gas Corporation's taxable income was sufficient in itself to cover the producing companies' losses and so enable the savings to be realized. It is completely arbitrary to regard Gas Corporation as having made the decisive contribution."

At the foundation of this argument is the assumption that the Commission properly treated United's non-jurisdictional activities and the Gas Corporation as regulated for the purpose of determining the income tax allowance to be included in United's jurisdictional cost of service. When the invalidity of this assumption is recognized, it becomes apparent, as shown earlier, that any effort to invoke United's jurisdictional taxable income as needed to realize the benefits of the System's non-jurisdictional tax losses, would be inconsistent both with the Commission's procedure here involved whereby "* * * any losses sustained by an unregulated company or activity must first be set off against the total income of *all* unregulated operations" (Comm. Br., p. 7) and with its express recognition in *Cities Service*, 30 F.P.C. at 162, that:

> "If we were to allocate the consolidated system tax return among all profit companies, *including those in whole or part engaged in unregulated activities*, there would be no sound reason for re-

fusing to fix jurisdictional rates at a level sufficient to make up any real losses these companies might suffer."

3. United's Jurisdictional Rate Payers Are Not Underwriters of, or Guarantors or Partners in, the United Group's Non-Jurisdictional Oil Business

The Commission further attempts to support its claim that United's jurisdictional rate payers may properly share in the benefits of the non-jurisdictional tax losses of the United Group by urging that "the rate payers [presumably of United's jurisdictional business] are * * * in effect underwriters of the investors' ventures" (Br., p. 21), and that "United's ratepayers were in effect partners of the system's investors in the gas and oil operations that gave rise to the tax losses and the resulting tax benefit." (Br., p. 22). This argument assumes as a fact that the jurisdictional pipeline activities support the non-jurisdictional production activities. It can as readily, and, we suggest, more readily be assumed that the converse is true, and that Union's non-jurisdictional activities contributes at least its full share to the corporate well-being of the United system. In any event, the record is void on this factual question, and, as indicated earlier, the argument is made for the first time in this Court in an effort to support the present position of the Commission.[15]

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[15] The Commission's brief also repeatedly mislabels gas pipelines as "public utilities," and even on one occasion refers to them as "franchised monopolies" (Br., p. 17). Gas pipelines have no franchised monopolies, and, accordingly are not public utilities in the sense commonly employed. Gas pipelines have no protected service areas, they have no statutory obligation to enlarge their facilities, and they are not common carriers (See Section 7(a) of the Act)

First, contrary to the Commission's repeated assertions on which these arguments are largely based, the "'profitability" of United's jurisdictional business is not "virtually guaranteed" (Br., p. 17), nor is there any assurance of a "steady stream of substantial profits" from such jurisdictional business (Br., p. 20), nor any obligation upon "United's ratepayers * * * to pay rates high enough to ensure a fair return to the pipeline's investors" (Br., p. 21). The fact is, as this Court has frequently admonished, that "regulation does not assure that the business shall produce net revenues." *F.P.C.* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 590 (1942); *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *Market Street Ry. Co.* v. *California Railroad Commission*, 324 U.S. 548, 566 (1945).

Second, even if there were an assurance of a steady stream of substantial profits with regard to United's jurisdictional business, it would not serve to make United's ratepayers in effect "underwriters" or "partners" in the non-jurisdictional activities of the United Group.[16] The rates paid by United's jurisdictional customers are fixed at a level no higher than necessary to enable United—if it actually makes jurisdictional sales at the level estimated at the time the rates are fixed—to recoup the cost of service (including a non-confiscatory return) *incurred in connection with its jurisdictional activities.* In other words, United's jurisdictional rates are determined without regard to the

[16] The Commission's suggestion that United provides an assured market for Union's *gas* production (Br., p. 21) is wholly beside the point since this case is concerned with tax losses from oil production. In any case, since there is no control over the location of gas reserves, gas found by Union may or may not be within economic distance from United's lines.

profits earned or losses incurred in connection with the United group's non-jurisdictional activities.

Indeed, as pointed out earlier, the Commission had always been careful to exclude all of the costs or expenses incurred in connection with non-jurisdictional activities from the jurisdictional cost of service. Thus, jurisdictional costs are determined as if the jurisdictional portion of United's business stood alone as a separate entity wholly distinct from the group's non-jurisdictional activities and the rates fixed for such jurisdictional business are unaffected by the success, or lack of success, of the group's non-jurisdictional activities.

In addition, the jurisdictional customers are under no liability to pay United's creditors for any of the costs or expenses incurred by United in connection with its jurisdictional business, should United become delinquent and fail to pay these obligations—even though they were incurred for the benefit of those customers. Much less would United's jurisdictional ratepayers be under any obligation to pay any of the costs or expenses incurred in connection with United's non-jurisdictional business and even less, those incurred by *Union* in either its jurisdictional gas business or non-jurisdictional oil business. Plainly, therefore, the payments by United's jurisdictional customers to United are nothing more than the traditional consideration paid by a customer for a conventional sale of a service or a commodity and do not involve any underwriting or guarantee obligation on the part of United's jurisdictional customers. *E.g. Board of Public Utility Commissioners* v. *New York Telephone Company,* 271 U.S. 23, 32 (1926); *Smith* v. *Illinois Bell Telephone Co.,* 282 U.S. 133, 158 (1930); *Hope Natural Gas Co.* v. *F.P.C.,* 134 F. 2d 287, 301 (4th

Cir. 1943), reversed on other grounds, 320 U.S. 591 (1944).

As a matter of fact, as in conventional sales, the jurisdictional customers have no concern with, or interest in, the monies which they pay over to United once they have made such payment, and all the "profits" if any, belong entirely to United's investors to do with as they see fit. By the same token, the decision whether to reinvest the "profit" in non-jurisdictional activities and if so, the extent thereof, is made solely by United's management and investors. Such decisions are of no concern to United's jurisdictional customers and they do not participate therein in any way. Patently, United's jurisdictional customers cannot validly be characterized as "partners" in Union's non-jurisdictional activities in any legal or practical sense.

Not only does the Commission itself even now shy away from characterizing United's jurisdictional customers as partners in the sense that they would be "entitled to share in the profits produced by [Union's non-jurisdictional] activities" (Br., p. 22), but the Commission has long since shied away from so regarding United's jurisdictional customers by recognizing in its *Cities Service* opinion, 30 F.P.C. at 162, the impropriety of "fix[ing] jurisdictional rates at a level sufficient to make up any real losses these companies might suffer."

In this regard, it may also be noted that even assuming, as the Commission argues (Br., p. 21), that "oil and gas production are intertwined," there is no substance to its further assertion (*Ibid.*) that "the backing that United's ratepayers supply Union's gas business perforce contributes to Union's oil ventures." For, in addition to the fact just noted, that United's

ratepayers do not supply any backing to Union's gas business, the Commission has always taken great care, including the most recent Union rate proceeding (see *Union Producing Co.*, 31 F.P.C. 41, 48-9, 71-3 (1964)), to separate Union's costs and expenses between its jurisdictional gas business and non-jurisdictional oil business. The "substantial correlation between the group's pipeline operations—supported by United's ratepayers — and its tax-loss production activities" claimed by the Commission (Br., p. 20) simply does not exist.

4. United's Jurisdictional Ratepayers Have Not Borne Any Increased Costs Attributable to Any Allegedly Greater Risks of the Oil Production Business of Union and Overseas

In further support of the propriety of the Commission's utilizing "a fair share of Union's tax losses" to reduce the income taxes allowed in United's cost of service, Memphis argues (Br., p. 21, see also Comm. Br., p. 21):

> "Exploration, development and production operations of Union involve higher degrees of risk and uncertainty than do the pipeline operations of United. This higher degree of risk is reflected in the cost of capital incurred by Corporation in raising capital, and is, in turn, reflected in the rate of return awarded United in light of that cost of capital. Thus, United's consumers bear increased costs of capital directly traceable to Union's riskier operations."

This argument is highly speculative, without any support either in the record or in the Commission's findings, and, indeed, at odds with the relevant available materials.

To be sure, as Memphis states (Br., p. 21) the Commission used the Gas Corporation's cost of capital along with other data it deemed pertinent in fixing United's rate of return. However, it does not follow that, as a result, United's jurisdictional cost of service included a higher cost of capital attributable to any alleged higher risks of Union's production business. The fact is that United's separate cost of capital—without reference to the other companies in the United group—was higher than that of the Gas Corporation. See *United Gas Pipeline Co.*, 25 F.P.C. 26, 110, 114 (1961). Hence, the use of the Gas Corporation's cost of capital, rather than that of United, resulted in a *lower* cost of capital being included in United's cost of service rather than a higher cost, as implied by Memphis.

Also, it should be noted that the rate of return approved by the Commission for Union in the *Union Producing* case utilized the cost of capital to the Gas Corporation *as recommended by Memphis.* See 31 F.P.C. at 74. Similarly, it should be noted that in fixing the rate of return to be included in United's jurisdictional cost of service in the instant proceeding, the Commission expressly pointed out that all parties had stipulated as to the proper rate of return and hence that there was no issue on the matter (See II R. 33). In other words, the Commission did not regard the Gas Corporation's cost of capital as being any the greater because of any greater risks or uncertainties attendant upon the group's production activities, whether jurisdictional or non-jurisdictional. To the contrary, in light of the alleged high profitability of Union's production activities, repeatedly adverted to by the Commission (Br. pp. 6, 11, 22, 23; see also Memphis Br. p. 7), the greater probability is that the Commission regarded these activities as *reducing*

rather than *increasing*, the Gas Corporation's cost of capital.

Finally, even assuming *arguendo* and contrary to the foregoing, that the Gas Corporation's cost of capital were higher than it otherwise would be as a result of Union's production operations, it would not provide any valid justification for utilizing "a fair share of Union's tax losses". (Memphis Br., p. 21) to reduce United's income tax allowance. In the circumstances thus assumed, it would have been incumbent upon the Commission to make findings as to the extent, if any, of such alleged higher cost of capital, and take the fact of such cost into consideration in computing the rate of return for United.[17]

B. The Non-Jurisdictional Tax Losses of Union and Overseas May Not Be Appropriated in Whole or Part To Reduce United's Jurisdictional Rates

Quite apart from whether, as a factual matter, the full benefits of the non-jurisdictional tax losses of Union and Overseas could be realized without the taxable income from United's jurisdictional business, use of all, or even a part, of the group's non-jurisdictional tax losses to reduce the income tax allowance included in United's cost of service and thereby passed on to United's jurisdictional customers, would be legally unsound.

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[17] Memphis' further argument (Br., pp. 14, 24-25) that the income tax allowance for United's jurisdictional business cannot be treated separately because "there is no separate *computation* or *assessment of tax* and no *separate tax liability* for each participant in a consolidated tax return" (emphasis in original) echoes arguments which were made by the Commission Staff in *Cities Service* but which were there expressly rejected by the Commission. See 30 F.P.C. at 160, 162.

1. Appropriation of the Non-Jurisdictional Tax Losses Would Frustrate the Purpose of the Offset Provisions of the Tax Laws

The effect of the provisions of the tax laws permitting the setting off of tax losses against taxable income is that the government waives the tax liability accruing from taxable income to the extent that the taxpayer has tax losses. In other words, the government agrees that it will assume 52 percent (at the then tax rate) of a taxpayer's tax losses to the extent that they can be met from the tax liability accruing from the taxpayer's income.

By providing for such offsets, Congress intended to mitigate the impact of loss operations and thereby to stimulate investments. This may be seen from the history of the tax provisions permitting net operating loss carryover (Int. Rev. Code of 1954, § 172). Thus, after describing the plight of new enterprises and capital goods industries, which are especially subject to wide fluctuations in earnings, the House Ways and Means Committee Report stated (H. Rep. No. 855, 76th Cong., 1st Sess. p. 9 (1939):

> "It is, therefore, believed that the allowance of net operating business loss carry-over will greatly aid business and stimulate new enterprises."

This view was echoed in the remarks on the floor of Congress. Senator Harrison explained (84th Cong. Rec. 7686 (1939):

> "Another important change in the law which was written in the bill as it passed the House and as it had been approved and reported by the Senate committee is the provision permitting corporations to carry over their net operating business losses for a period of 2 years. In my opinion, that is one of the most important provisions in-

corporated in this legislation, and *one which perhaps will give more encouragement to business than any other provision* * * *.'"[18]

The same principle is involved in the consolidated tax return provisions (Int. Rev. Code of 1954, §§ 1501-4) which, instead of offsetting profits and losses lineally over a period of time, offset them horizontally within associated corporate organizations.

The practical effect under both provisions is that the *government* is sharing with the stockholders the losses of a company. Put another way, from a realistic point of view, what is involved is a payment of taxes on certain operations, which is then turned back or forgiven by the government because of the tax losses incurred in connection with other operations. *These tax deductions reduce a minus* (*loss*). *They do not add a plus* (*profit*). And it makes no difference whether the losses are offset through the filing of a consolidated return or utilizing the carry-back and carry-forward provisions of the Code.

In view of the clear purpose of these offset provisions to stimulate investment, it is apparent that the effect of appropriating for United's jurisdictional customers all or even part, of the benefits of the non-jurisdictional tax losses is to deprive the United group of the benefits of the tax losses thus appropriated, and, to that extent, to destroy the incentive which Congress intended by these provisions. In this regard, it cannot be over-emphasized that it is the *government* that is sharing Union's losses, not the customers of the jurisdictional segment of United's business. As al-

[18] As noted earlier, the carry-forward period is now five years and the carry-back period is three years.

ready shown above, the cost of service, on the basis of which United's jurisdictional rates are fixed, does not include any part of the expenses, costs, or losses attributable to Union's and Overseas' non-jurisdictional business. Moreover, inclusion of an income tax allowance in United's jurisdictional cost of service computed on the basis of the full statutory rate would not redound unfavorably against United's jurisdictional customers since they would pay the same rates as they would pay if United had no affiliates engaged in non-jurisdictional operations and had filed a separate return. Thus the jurisdictional customers of United would not be affected unfavorably, in terms of rates by the United group's non-jurisdictional operations. In these circumstances, to deny to the group the benefits which are available to other (nonregulated) companies merely because Union and Overseas were joined in a consolidated return with a company (United) which has operations which are the subject of regulation would frustrate the purposes and objectives involved in permitting tax offsets of losses.

2. The Appropriation of Non-Jurisdictional Tax Losses Would Improperly Impair the Ability of Regulated Companies Effectively To Compete With Non-Jurisdictional Businesses

Requiring that all or part of the benefits of non-jurisdictional tax losses be passed on to jurisdictional ratepayers would impair the ability of regulated companies effectively to compete in non-jurisdictional areas either directly or through affiliates. While a regulated company may be willing to enter upon a new non-jurisdictional venture, knowing that by virtue of the offset provisions in the Internal Revenue Code, the government would bear 52 percent (now 48 percent) of the early losses, it might well be deterred from

embarking upon such new enterprise if it were required to give to, or share with, the customers of its jurisdictional business the benefits of such tax losses. For, in these circumstances, the company engaged in both jurisdictional and non-jurisdictional activities would have to absorb substantially more than 48 cents (now 52 cents) of each dollar of operating tax loss, while its wholly unregulated competitors would be able to offset their tax losses fully against their taxable income and thereby bear only 48 cents (now 52 cents) of each dollar of tax loss. In short, the latter companies would have a distinct competitive advantage over the companies engaged in part, or through affiliates, in regulated activities.

The requirement that a company engaged in both jurisdictional and non-jurisdictional businesses give or share its non-jurisdictional tax losses with the customers of its jurisdictional operations, would, by the same token, also deter companies engaged solely in non-jurisdictional enterprises from undertaking or acquiring ventures which would be subject to the Commission's jurisdiction. Clearly, this would be the logical consequence since they would no longer be permitted to retain the full benefits of their tax losses as they had done prior to entering into jurisdictional operations.[19]

That the diversion of non-jurisdictional tax losses to jurisdictional customers would impair the ability of a company engaged in both jurisdictional and non-juris-

[19] In this regard, it is to be noted that there is no restriction imposed by Congress or any other body or agency upon the nature of the non-jurisdictional (non-utility) activities in which a gas company (or its parent) may engage because of the fact that directly or through affiliates it is engaged in activities subject to regulation by the Commission.

dictional operations to compete with wholly unregulated enterprises may be illustrated by reference to the oil exploration and production business, the primary non-jurisdictional business in which Union is engaged. Union's ability to survive in this highly competitive business obviously would be adversely affected if Union were deprived of any part of the benefits of these tax losses in order to pass them on to United's jurisdictional customers while Union's competitors were able (for a period of nine years) to retain all such tax benefits irrespective of whether their tax returns are filed on an individual company or consolidated return basis. As summarized by the dissenting Commissioners in the *Cities Service* case, 30 F.P.C. at 175:

> "* * * Following the theory of the majority, how can an integrated oil company which also has a natural gas pipeline company within its corporate structure, compete on equal terms with an oil company not having similar pipeline operations, if the latter can use all of its tax savings in the oil business but the former cannot? Clearly, it cannot so compete."

As already shown above, United's ratepayers were not asked to—nor did they provide—any of the money invested in Union's non-jurisdictional activities. Nor do they bear any of the risks, losses or expenses associated therewith. In sum, even without the benefits of these non-jurisdictional tax losses, the rates paid by United's jurisdictional customers are no higher than they would be if United were only a jurisdictional company not affiliated with any company engaged in non-jurisdictional activities. There, accordingly, is simply no basis or justification for utilizing all or even a part of the tax losses resulting from Union's non- ju-

risdictional operations to bestow a wholly gratuitous windfall upon United's jurisdictional customers.

The impropriety of such a result becomes even clearer when viewed from the standpoint of a minority stockholder. An affiliate may be included in a consolidated return filed under Section 1501-1504 of the Internal Revenue Code, so long as the parent corporation owns 80 percent or more of the voting stock of such affiliate. In such circumstances, the minority stockholders of an affiliated company having non-jurisdictional tax losses obviously would want to insist that these tax losses be utilized in a manner which best furthers the interests of that company, and not be appropriated for the jurisdictional customers of an affiliated company, in which the minority stockholders have no interest. But if such tax losses are used to reduce jurisdictional rates, the minority stockholders lose the benefit of the carry-over provisions of the Code, with a concomitant loss of profits which would otherwise proportionately inure to them.

3. The Appropriation of Non-Jurisdictional Tax Losses Would Improperly Deprive the Gas Corporation of Its Property

Under Sections 1.1502-34 and 1.1502-35 of the Income Tax Regulations, where a subsidiary could not have utilized losses under Section 172 of the Internal Revenue Code to reduce its own taxable income for any year, the parent company's tax basis on its investment in that subsidiary is reduced by the amount of the loss utilized through the consolidated return. As a result, should the Gas Corporation sell or abandon the non-jurisdictional operations of Union or Overseas, it would be deprived of the use of the losses which had previously been offset through the use of consolidated

returns. The Gas Corporation, of course, would not be adversely affected if it had benefited fully from utilizing the losses in the consolidated returns to reduce its taxable income. However, should the benefits of any part of those losses be used to reduce United's jurisdictional rates, as the Commission urges be done, the Gas Corporation obviously would be adversely affected. For it would be presumed, under the above Regulations, that the United group had taken advantage of such losses, whereas, in fact, part of those losses would have been appropriated to reduce United's jurisdictional rates.

4. The Appropriation of the Non-Jurisdictional Tax Losses Would Conflict With Oil Exploration and Development Incentives

It is, of course, well known that Congress has allowed special tax benefits for oil exploration and development in the form of percentage depletion and expensing intangible drilling costs. Indeed, the Commission repeatedly claims that Union has in fact had net substantial income and incurred tax losses only because of these special tax provisions (Comm. Br., pp. 6, 11, 22, 23, see also Memphis Br. p. 7). Consequently, since the purpose of these tax provisions is to encourage exploration and development of mineral resources including oil, the effect of appropriating for United's jurisdictional customers all, or even part, of the benefits of these non-jurisdictional tax losses is, to that extent, also to put to naught the Congressional purpose underlying this tax provision.

A recent statement of this Court as to the purpose of percentage depletion is in *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 81 (1960):

> "In summary, mineral depletion for tax purposes is an allowance from income for the exhaustion of capital assets. *Anderson* v. *Helvering*, (1940), 310 U.S. 404. In addition, it is based on the belief that its allowance encourages extensive exploration and increasing discoveries of additional minerals to the benefit of the economy and strength of the Nation. * * *"

The Congressional purpose to encourage investment in oil operations is also evident from the legislative history of the deductions for percentage depletion,[20] and for intangible drilling and development costs.[21] As noted in *El Paso Natural Gas Co.* v. *F.P.C.*, 281 F. 2d 567, 571 (5th Cir. 1960), *cert. denied*, 366 U.S. 912 (1961): "It has * * * been recognized not only by Congress but by the courts as well that there is a public interest in the creation of an incentive to cause additional exploration and development in the oil and natural gas industries."

Congress intended the incentive benefits of percentage depletion to apply not only to domestic oil exploration, but also to foreign oil operations like those of Overseas. For, unlike the percentage depletion rate of many minerals, which depends on whether the de-

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[20] The legislative history of depletion allowance is discussed in 4 Mertens, *Law of Federal Income Taxation*, §§ 24.04-24.15b (1960) and in *Legislative History of Depletion Allowances*, Staff of the Joint Comm. on Internal Revenue Taxation, 81st Cong., 2d Sess. (Comm. Print 1950).

[21] For details concerning the legislative history of intangible drilling costs see *e.g.*, Fielder, *The Option to Deduct Intangible Drilling and Development Costs*, 33 Texas L. Rev. 825, 826-30 (1955); Mahin, *Deduction for Intangibles*, Southwestern Legal Foundation, Second Annual Institute on Oil and Gas Law and Taxation 367, 369-78 (1951).

posits are in the United States or elsewhere, the depletion rate for oil remains 27½ percent whether the oil well is located in the United States or elsewhere. See 4 Mertens, Law of Federal Income Taxation, §§ 24.15b; 24.23c. fn. 73.

Memphis (Br., pp. 19-20; see also Comm. Br., pp. 21-25, 27) contends that the *El Paso* case supports its position. But inasmuch as the Fifth Circuit had also decided *El Paso,* its failure even to mention that case in its decision herein strongly indicates that it did not regard its holding in *El Paso* as contrary to its ruling here. There is good reason why this is so. To be sure, the Fifth Circuit in *El Paso* had remanded the Commission's order (22 F.P.C. 260), which had allowed El Paso to retain the tax benefits resulting from the deductions for intangible well drilling expense and percentage depletion. But the fact is that the tax benefits there involved arose solely from tax deductions applicable to El Paso's *natural gas* production business. Indeed, although one might get a broader impression from a casual reading of Memphis' brief, Memphis, in essence, concedes this fact. The key to the limitation upon Memphis' claim is its description of El Paso as a company "engaged in the production, transportation and sale of *natural gas*". Significantly Memphis does not even mention El Paso's non-jurisdictional oil operations.

That the Fifth Circuit's *El Paso* holding does not in fact relate to the tax deductions applicable to the company's oil operations is clear from the court's opinion as well as from the fact that the Commission did not purport to treat with the company's *oil*

production.[22] While the court stated, as quoted by Memphis (Br., p. 21):

> "* * * It is the obligation of all regulated public utilities to operate with all reasonable economies. This applied to tax savings as well as economies of management. The net result of this, of course, is that such savings as are effected are passed on to the consuming public. This we consider to be the natural and necessary consequence of rate regulation,"

the Fifth Circuit plainly could not have intended to hold that El Paso's "public utility" *obligation* required it to operate with all reasonable economies with regard to its non-jurisdictional and unrelated *oil* operations. Moreover, since El Paso's oil activities are not subject to "rate regulation," whatever disposition is made of its "tax savings" resulting from its *oil* operations surely could not be "the natural and necessary consequence of rate regulation." See, also, 30 F.P.C. at 189.

III

The Applicable Precedents Support the Result Below, Rather Than That Urged By Petitioners

Memphis (Br. p. 15, see also p. 9) refers to a number of past Commission decisions as support for its thesis that the Commission's action here

> "adhered to its long-established, administrative practice of including in cost of service an allow-

[22] A comparison of the Commission's *El Paso* opinion with the record in that case clearly reveals that in accordance with the limitations on its jurisdiction discussed earlier in this brief, the Commission excluded from the determination which it there made all items relating to El Paso's *oil* production, such as percentage depletion based on *oil* revenues and the deductions for intangible drilling expense of *oil* wells.

> ance only for taxes actually incurred. Where the company has participated in a consolidated tax return, the Commission has consistently refused to include a hypothetical tax allowance in cost of service based on a separate tax return. The Commission has included in cost of service only a tax allowance at the effective tax rate resulting from participation in the consolidated tax return."

Similarly, but referring to a markedly smaller group of cases, the Commission (Br., p. 14) argues that "with one exception [it] has been consistent in requiring allocation" in circumstances where a regulated company has participated in a consolidated filing. As shown below, these cases are distinguishable and do not support the position of the Commission or of Memphis. As a matter of fact, the cases which do deal with the question here involved are fully in accord with the decision of the court below.

A. The Commission Had Not Previously Contended That It Could Appropriate Non-Jurisdictional Tax Losses to Reduce Jurisdictional Tax Allowances

In relying on the several Commission cases that they do, both the Commission and Memphis gloss over the critical distinction between jurisdictional and non-jurisdictional operations. None of the cases thus referenced by Memphis and the Commission involve the appropriation for the purchasers of gas subject to the Commission's jurisdiction of the benefits of tax losses incurred in unrelated, non-jurisdictional activities. Indeed, in those cases, the Commission neither considered nor discussed whether it could properly use a so-called "consolidated effective tax rate" in circumstances such as those presented here. As summarized by the dis-

senting Commissioners in *Cities Service,* 30 F.P.C. at 171:

> "While the Commission, in the past, has properly insisted that certain tax advantages to be obtained from filing a consolidated return for groups composed entirely, or predominantly, of regulated companies, be passed on to consumers, it has not held that business losses of unregulated and unrelated corporations participating in a consolidated return should be utilized for the benefit of the consumers of a regulated natural gas company. * * *"

Thus, although the Commission's decisions in the cases now relied upon by Memphis and the Commission are cast in terms of reducing the allowable tax below the amount to which the company would have been entitled had it filed a separate return, the real question in those cases generally was that of determining an equitable allocation of tax deductions, particularly interest expenses, incurred by a parent *on behalf* of its subsidiaries. In other words, the real problem was that of allocating to jurisdictional operations the costs *associated therewith.* These problems arose because the parent company in the systems involved in most of the cases had issued debt securities for the financing of its affiliates and "neither respondent nor any other operating gas company * * * has any funded debt outstanding." See *Pub. Util. Comm.* v. *Manufacturers Light & Heat Co.,* 5 P.U.R. 3d 346, 382 (Pa. PUC, 1954) (Columbia System).[23] Accordingly, in such systems, the use of a tax adjustment "is merely the return to the company of that part of the additional

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[23] This was the situation in *Southwestern Bell Tel. Co.* v. *Kansas State Corp. Comm.,* 192 Kan. 39, 386 P. 2d 515, cited by the Commission in its Brief (p. 22, fn. 23).

expense imposed upon it by the method of financing chosen by its parent. * * *" See *Re Chesapeake & Potomac Teleph. Co.*, 6 P.U.R. 3d 222, 244 (D.C. PUC 1954).

Inappropriate for this reason are the references by the Commission and Memphis to the Commission's decisions involving affiliates of the Consolidated Natural Gas System and of the Columbia Gas System, in both of which systems the parents provide the financing for the subsidiaries. *Hope Natural Gas Co.*, 10 F.P.C. 583, 612 (1950), *aff'd as modified*, 10 F.P.C. 625 (1951); *Hope Natural Gas Co.*, 12 F.P.C. 342, 347 (1953); *Atlantic Seaboard Corp.*, 11 F.P.C. 486, 514-15 (1951), *aff'd as modified*, 11 F.P.C. 43 (1952), *remanded on other grounds*, 200 F. 2d 108 (4th Cir., 1952); *United Fuel Gas Co.*, 12 F.P.C. 251, 264-5 (1953); *Home Gas Co.*, 13 F.P.C. 241 (1954); *United Fuel Gas Co.*, 23 F.P.C. 127, 135, n. 15 (1960), *modified in other respects*, 23 F.P.C. 512 (1960).[24]

Penn-York Natural Gas Corp., 5 F.P.C. 33, 38-9 (1946), which is also cited in this connection, is not different from the aforementioned decisions involving equitable allocation of interest expense. Not only is this apparent from the Commission's perfunctory dis-

[24] In *Michigan Wisconsin Pipe Line Co.*, 13 F.P.C. 326, 358-9, 373 (1954), to which Memphis also refers, there is nothing in the Commission's opinion to reveal the basis of the reduced tax allowance. However, inasmuch as the company there did not question the propriety of a reduced allowance but merely the amount thereof (13 F.P.C. at 373), there is a strong presumption that, as in the cases discussed in the text, the tax adjustment was merely the means for allocating to Michigan Wisconsin the portion of the deductible expenses incurred on its behalf by its parent. In any case, inasmuch as the propriety of the Commission's action was not questioned, that case obviously does not constitute a precedent.

cussion of the income tax issue in that opinion, but, indeed, the Court of Appeals for the Fourth Circuit has so construed the decision. *South Carolina Generating Co.* v. *F.P.C.*, 261 F. 2d 915, 920 (4th Cir., 1958).[25]

B. The Decisions Dealing With the Problem Here Presented Fully Support the Court Below

In contrast to the several Commission cases which are relied on by Memphis and the Commission and which are clearly distinguishable, the case which the Commission would now classify as the exception to its alleged prior "consistent practice", namely, *Olin Gas Transmission Corp.*, 17 F.P.C. 685 (1956), is the *only* prior Commission decision (other, of course, than *Cities Service*) specifically dealing with the issue here presented. In that case, the Commission recognized the impropriety of bestowing upon the customers of the jurisdictional company in the form of reduced rates the benefits of the tax losses incurred in connection with non-jurisdictional activities of an affiliate.

Thus, in the *Olin* case, the parent of the jurisdictional company had filed a consolidated tax return for

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[25] Interestingly enough, in the *South Carolina Generating* case, from which the Commission seeks also to derive some comfort (Br., p. 22 fn. 23) the Court of Appeals held that "the actual costs should not be disregarded simply because the selling utility chooses to incur them in one place rather than another" (261 F.2d at 920), after earlier noting that the Commission "took into account only the income taxes which the Generating Company is obliged to pay as a separate corporate entity but failed to include the additional tax incurred by the corporate system as a whole because of the establishment and operation of the subsidiary body" (261 F.2d at 917).

Similarly irrelevant here are the cases cited in the Commission's Petition for Certiorari (at p. 8, fn. 13), since they do not involve non-jurisdictional tax losses.

1954 in which, because of the tax losses of the parent's non-jurisdictional operations, no tax had been paid. The argument was made that no tax allowance should be included in the jurisdictional company's cost of service. The Presiding Examiner rejected the argument and held that the jurisdictional company should be allowed the full amount of taxes computed as if it had not participated in a consolidated return, stating (17 F.P.C. at 693-4):

> "* * * Olin (and its predecessor) as a corporate entity had a legal liability in the year 1954 for the payment of Federal Income Taxes on net profits from operations in the amount of $3,124,343. Such Federal income tax liability on $3,124,343 was discharged by the operation of the crediting provisions of Federal Internal Revenue laws permitting the consolidation of returns of Olin and its affiliated corporations and the crediting of net profits against net losses within the system. As a matter of fact and of law Olin satisfied its Federal income tax liability in 1954. Olin, as a matter of law, applied to it as a company subject to rate regulation by this Commission (and not as a component of a system over which this Commission has no jurisdiction to regulate rates) had a computable tax liability in 1954 of $897,537, which is recognized as a lawful revenue deduction in determining just and reasonable rates. *Any other action would penalize Olin as an affiliated member of a corporate system.*"

On exceptions to the Commission, the Commission agreed with the Examiner (*Id.* at 703):

> "* * * The reason the consolidated return reflects no income taxes for Olin was in part due to losses generated by [the parent company] from *unregulated business activities unrelated to Olin's natural gas operation. This* and other circumstances

justify the allowance for state and federal income taxes which [the applicant] has included in its jurisdictional cost of service.'"[26]

The Commission's *Olin* decision accords with those of various State courts and regulatory authorities. In *Southern Union Gas Co.* v. *New Mexico Public Service Commission,* No. 31074 D. Sante Fe County, New Mexico (June 9, 1961), the tax allowed the company by the Commission was less than that computed on the basis of the net operating income attributable solely to the company's New Mexico public utility operation, since the Commission had allowed the company only a portion of the tax calculated as "actually payable" on the company's total operations (utility and non-utility). In annulling the Commission's order, the Court held that the State Commission must compute the tax allowance for the utility operation without regard to the income tax effect of the company's non-utility operations, stating:

"The Commission erred in not determining the Federal income tax allowance by computing the amount of tax liability which is directly associated with and attributable to Petitioner's appropriate New Mexico utility operating income, before Federal income tax, without regard to the income tax

[26] While the Commission in the *Olin* case stated that the case was *sui generis* (see 17 F.P.C. at 696), that statement was addressed to the Commission's disposition there of the problem of valuing a pipeline company's own produced gas for which the Commission was then groping for a solution. This *caveat* was intended to make clear that the Commission did not regard its decision as constituting the solution to that problem and so should not be construed as a precedent on that matter. No such situation confronted the Commission there with regard to the tax issue and hence there is no reason to regard its disposition thereof as *sui generis,* particularly in light of the rationale underlying this action.

effect of Petitioner's other businesses and activities and expenses which are treated by the Commission as non-utility in character."

Similar conclusions have been reached by the Indiana, Kentucky, Pennsylvania, New York and Washington Commissions. Thus, in *Kokomo Water Works Co.*, C.C.H. Utilities Law Rep., Par. 18,513 (Ind. P.S.C., 1959), the Indiana Commission, in fixing the tax allowance for a subsidiary, refused to reflect a so-called "consolidated effective tax saving" which arose "solely from tax deductions attributable solely to the parent company or to losses sustained by other operating companies." It stated (Pas. 18,513.04):

> "We find that Petitioner's utility operations should be measured on their own, *Public Service Commission v. Indiana Bell Telephone Co.* (1956), 235 Ind. 28-29, and just as additional expenses arising from other affiliated companies could not be attributed to Petitioner, so likewise, expense deductions attributable to other affiliated companies cannot be. Petitioner's earnings must be sufficient to cover all expenses, including income taxes, attributable to its own operations, regardless of whether the owner of its stock may have deficits or deductions elsewhere to reduce its overall tax liability."

In *Re Union Light, Heat & Power Co.*, 97 P.U.R. (n. s.) 33, 40 (Ky. P.S.C. 1953), the Kentucky Commission computed tax expense for the company's gas and electric operations without regard to tax savings resulting from losses in the company's water operations. The Commission held (97 P.U.R. (n. s.) at 40):

> "Several adjustments are necessary for Federal and state income taxes. The gas and electric operations receive the benefits of certain tax savings due to the loss sustained in Union's water opera-

> tions. Inasmuch as we are considering the gas and electric operations alone in these cases, the Commission is of the opinion that these tax savings should be eliminated from the gas and electric operations inasmuch as they are assignable solely to the water operations."

In *Pub. Util. Com'n,* v. *Sunbury Water Co.,* 29 Pa. P.U.C. 321, 337-8 (Pa. P.U.C. 1951), the Pennsylvania Commission held that, in computing income taxes for the water company, it would give no effect to losses from the company's ice business. As the Commission viewed the problem (29 Pa. P.U.C. at 337):

> "* * * If a profit were realized from the ice business, unless it were negligible, we would not be justified in including that profit in determining allowable income taxes to be paid for by respondent's customers. Conversely, any loss realized would not enter into such determination of income taxes."

Similarly, the New York Commission has disregarded non-jurisdictional losses in computing allowable tax expense for jurisdictional operations. In Re *Rates and Rate Structures,* 29 P.U.R. (n. s.) 391, 481-2 (N.Y. P.S.C. 1938), involving an investigation of gas and electric rates, the Commission computed taxes separately for the profitable electric and unprofitable gas departments of the Queens Borough Gas & Electric Company. As a result, the taxes assigned to the electric department exceeded the computed so-called "actual taxes payable" in three of the five periods under review. Likewise, in *Re Staten Island Edison Corp.,* 60 P.U.R. (n. s.) 385, 479-80 (N.Y. P.S.C. 1945), the New York Commission computed tax expense of a subsidiary without regard to losses sustained by other companies in the system. It said (60 P.U.R. (n. s.) at 480):

"* * * In 1943, the company accrued $277,000 for Federal income tax purposes. The accrual represented the estimated amount of tax the company would pay in a consolidated tax return with other companies in the Associated System. Although the tax rate is slightly higher on the basis of a consolidated tax return, the amount of tax in this instance is less than what it would be under a separate return because of the benefit received from taxable losses sustained by other companies in the Associated System. For the purpose of this determination, the Staten Island Edison Corporatoin will be allowed the amount of Federal income tax it would be required to pay on the net income applicable to its electric operations on the basis of filing a separate return."

CONCLUSION

For the foregoing reasons as well as those set out in the briefs filed herein by respondents, it is respectfully submitted that should the Court reach the merits, then the judgment below should be affirmed.

Respectfully submitted,

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